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A legal update from Dechert's Financial Services Group

SEC Guidance on Side Letters

Hedge fund managers sometimes provide certain investors in hedge funds with side letters granting terms that are different from those granted under the fund's standard offering documents. Many in the hedge fund industry have expressed concern regarding how such side letters are viewed by the Securities and Exchange Commission ("SEC").

In the absence of public pronouncements by the SEC or SEC staff, speculation has run the gamut from the extreme view that all side letters are suspect and should be avoided, to the view that hedge funds should continue business as usual. Recent Congressional testimony by a senior staff member of the SEC has shed some light on the current thinking of the SEC staff.

The SEC Staff Testimony

In testimony covering various topics before the U.S. Senate, Susan Ferris Wyderko, former Acting Director of the SEC's Division of Investment Management, stated that hedge fund side letters are indeed a concern of the SEC staff.[1] However, as described below, she also provided a window into which terms in side letters raise more issues than others.

Terms of Little Regulatory Concern

- The ability to make additional investments
- "Most favored nation" clauses
- Management fee and performance compensation reductions

[1] Susan Ferris Wyderko, Testimony Before the Subcommittee on Securities and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs (May 16, 2006).

Terms SEC Staff Finds "Troubling"

- Liquidity preferences
- Preferential access to portfolio information

Ms. Wyderko made it clear that side letters will continue to be reviewed during SEC examinations of hedge fund advisers that are registered with the SEC, and that the SEC staff will evaluate whether appropriate disclosure of side letters and relevant conflicts has been made to investors.

Analysis

The hedge fund industry, following SEC staff positions, has typically viewed negotiated reductions in fees as acceptable where disclosure of such practices has been made in the related offering document. Not surprisingly, the testimony demonstrated little concern about this practice. We believe this is because fee reductions generally do not result in potential harm to other investors. The testimony should not, however, be viewed as a signal to decrease disclosure regarding this practice.

Potential conflicts among investors may be more direct where side letters grant liquidity preferences to certain investors. For example, the preferential early exit of one investor may reduce portfolio liquidity, which might make withdrawals unavailable to other investors. Consideration should be given to whether the nature and scope of the rights are consistent with treating all investors fairly, albeit not equally.

Granting certain investors preferential access to portfolio or performance information has a long history in the hedge fund business.[2] Larger investors often have more market power, and some investors are simply better able to analyze the data than others. Beyond disclosing the practice, managers and boards should consider whether the timing, nature, and extent of the information are likely to put the fund at risk (from front running or the like), or to provide knowledge that the recipient may use in a way that harms the other investors.

Managers need to consider early on what future side letter provisions are likely to be given in a particular fund to avoid later investors being given special rights not disclosed in offering documents provided to earlier investors. In some jurisdictions, shareholders in each share class must be treated identically, so the fund must be created with the flexibility to create and issue new share classes.[3] Once a fund has been formed, managers should ensure new side letters do not conflict with applicable law or any prior fund agreements, including the fund's organizational documents, offering documents, and previous side letters.[4] Side letters should also be reviewed to ensure they do not change the regulatory status of the fund.[5]

Managers and boards that carefully consider the appropriateness of any rights granted and provide sufficiently robust disclosure ought to be able to avoid problems with the SEC staff. However, they should be prepared to demonstrate to the SEC staff why the terms of any side letters are appropriate and why disclosure was sufficient. In addition, managers and fund boards must not neglect to consider their fiduciary duties to investors, beyond any duties explicitly imposed by applicable federal securities laws and regulations.

One question left open by the testimony is whether managers need to disclose the exact terms of particular side letters. We believe that such disclosure is generally not necessary. Depending upon the exact terms and their potential to cause conflicts of interest among investors, clear but general disclosure of what terms the manager may provide in side letters should suffice in virtually all cases.

Interestingly, the Financial Services Authority of the United Kingdom (the "FSA") has recently indicated that side letters are the subject of regulatory focus.[6] In a press release describing its recent feedback statement on hedge fund risks, the FSA commented that "the failure by hedge fund managers to disclose that side letters have been granted to certain clients may result in some investors receiving more information and preferential treatment to other investors in the same share class."[7] The FSA added that it expects "managers to ensure that all investors understand that a side letter has been granted and that conflicts may arise."

The detailed feedback statement commented that it expects disclosure "when a side letter is granted," but not disclosure of the exact content of side letters. The FSA also expects managers to "adequately manage" any conflicts rather than focusing just on disclosure. Industry consultation with the FSA is continuing and the FSA is expected to give further guidance later in the year.

While U.S. regulatory guidance currently focuses on disclosure and not explicitly on management of conflicts,

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2 For a description of disclosure practices in the hedge fund industry, see generally *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (Sep., 2003) at section IV.D.

3 *See, e.g.*, Mark Lewis, *Side letters* (Jul. 12, 2005), available at the website of Walkers, www.walkers.com; Spencer Privett, *Hedge Funds in the Cayman Islands* (Feb. 2004), available at the website of Maples and Calder, www.maplesandcalder.com (noting that Cayman Islands funds require that shareholders in each class be treated identically); Robert J.D. Briant, *Hedge Funds: The Perils of Side Letters* (Apr. 2004), available at the website of Conyers Dill & Pearman, www.cdp.bm (noting similar treatment for funds organized in the British Virgin Islands).

4 Aside from being an invitation to litigation, side letter terms that conflict with the fund's organizational documents might be unenforceable in some jurisdictions. *See, e.g.,* Briant, *supra* note 3.

5 For example, if one investor is given the opportunity to redeem shares within two years, the fund's manager might become subject to a registration requirement under the Investment Advisers Act of 1940. *See Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Release No. IA-2333 (Feb. 10, 2005), at n. 233.

6 FSA Feedback Statement 06/2 (Mar. 2006). Similarities between U.K. and U.S. regulatory guidance should not be surprising, given concerted efforts to reduce differences between U.S. and U.K. financial regulatory requirements. *See, e.g., The Practical Implications of SEC Regulation outside the United States*, speech by John Tiner, Chief Executive of the FSA (Feb. 17, 2004) ("The growing similarities of the U.S. and E.U., especially the U.K., capital markets, makes it increasingly of practical importance that regulatory authorities on both sides of the Atlantic work to reduce unnecessary differences in standards that might create barriers to entry and hinder the growing inter-dependence of the two markets.").

7 *Feedback Statement on DP05/4: Hedge Funds Discussion Paper Released*, FSA Asset Management Newsletter, Apr. 2006, at 4.

U.S. managers who fail to properly manage their conflicts may find the burden of disclosure painfully high.

Conclusion

While the SEC staff has not sought to eliminate side letters, the SEC staff is concerned about arrangements which may result in conflicts among investors. At the present time, the SEC staff has focused on disclosure as the remedy.

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